No. 9393

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CO-OPERATIVE OIL ASSOCIATION, INC.,
an Association,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF OF PETITIONER

Upon Appeal from the United States Board of Tax Appeals.

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Replying to Respondent's brief, may it first be noted that Respondent now bases his entire case upon the proposition that the right of Petitioner's members to the savings involved "would not become fixed until an affirmative act of appropriation on the part of the Board of Directors" (see Summary of Argument, p. 7); and thus seeks to sustain the decision of the Board of Tax Appeals, which premised its decision upon an entirely different ground, namely: that although such right to such savings existed and there was an obligation and liability on the part of Petitioner to its members for such savings, the Board of Directors had excluded such particular savings by setting them aside in a reserve such as contemplated by the Articles of Incorporation.

As pointed out in our opening brief, manifestly no such reserve was ever set up by the Board of Directors. Article X of Petitioner's Articles of Incorporation provides for the

setting aside of certain reserve funds by the Board of Directors. The evidence showed that the only reserve fund thus ever set aside by the Board of Directors was "a reserve for contingencies, obsolescence and extensions" (Petitioner's brief, p. 13). Respondent in his brief does not even attempt to sustain the Board of Tax Appeal's statement that the savings involved herein were ever set aside as a reserve within such Articles, and although challenged so to do, counsel do not point out any reference in the record to the setting up of any such reserve by the Board of Directors.

Thus abandoning the basis of the Board's decision, counsel revert to a necessity for some affirmative act of appropriation on the part of the Board of Directors. As set forth at length in Petitioner's brief (pp. 20-23), the rule is whether there actually was an obligation or liability to the patrons for the savings involved, and if so, an affirmative or other act of appropriation or an entry in recognition of such liability or otherwise was immaterial.

The misconception of counsel is apparent from the statement on page 9 of Respondent's reply brief where it is said that the proceeds "from sales to its members belonged to the corporation." So, likewise, the statement at the bottom of said page 9 and top of page 10, to the effect that the interest of Petitioner's patrons in savings "is not greater than that of a stockholder in an ordinary corporation," and that the right to such savings "ripens into * * right of ownership only upon actual declaration by the Board of Directors," indicates clearly the fallacy of counsel's argument.

No attempt is made to answer Petitioner's argument under the statutory provisions pursuant to which Petitioner was organized. As set forth in our opening brief, page 20, Petitioner under the statute pursuant to which it was organized was not organized for a profit either for itself or for its members as such or as stockholders, but only as producers. The provisions of the statute, Articles and By-Laws are all framed upon this same theory, that the savings belonged neither to the association nor its stockholders nor members, but solely to the producers; yet counsel have the temerity to ignore the statutory provisions, the Articles of Incorporation, By-Laws, and marketing agreements, and blandly state that the interest of the patron in a cooperative association in the State of Idaho "is not greater than that of a stockholder in an ordinary corporation" (Brief, p. 10).

Counsel then proceed to close their eyes to the intention of the parties involved. The mere fact that the savings were being used pending distribution does not constitute such funds as a "reserve" as contemplated by the Articles. The authority in the Board of Directors to set up a reserve such as mentioned by the Board of Tax Appeals was exercised as shown by the record in setting up a reserve for "contingencies, obsolescence and extensions." But no other reserve was set up, and the savings involved were not so set aside in such a reserve.

No corporate action was necessary to set up a liability for the savings, whether distributed or undistributed, to Petitioner's members. The statements contained in the Articles, By-Laws and marketing agreements are unequivocal in

establishing the right of members to these savings. Stripped of all non-essentials, they read: "The net income of this corporation * * * shall be distributed to the stock-holding patrons * * * who have signed the corporation's purchasing agreement on the basis of their patronage * * *." There is no discretion in Petitioner's Board of Directors. The liability and the duty is fixed. In other words: under the theory and the statutory provisions of the Cooperative Marketing Act of the State of Idaho, and the Articles and By-Laws made pursuant thereto, no action on the part of the Board of Directors is necessary to make such savings subject to distribution to members, or necessary to create a legal right in the members to demand and receive the distribution of such savings. The right to set up the reserve for contingencies, obsolescence and extensions above mentioned is merely a limitation on this legal right of members and the obligation to them for such savings.

Counsel's error is quite apparent from the principal case upon which they rely in the closing paragraph of their brief (p. 12), Fruit Growers Supply Co. case, 21BTA 315, 327. It illustrates Respondent's misconception that the Cooperative Marketing Act of Idaho and the Articles pursuant thereto are in no sense any different from those involved in the cases cited in their brief. In the Fruit Growers Supply Company case it was said that the by-laws provide it shall be the duty of the directors to "declare dividends out of surplus profits when such profits shall, in the opinion of the directors, warrant the same, subject to the provisions" of another

section wherein it is provided that the directors are authorized to prescribe "the time and manner of readjustment with or refund to its patrons."

Manifestly these provisions are diametrically opposite to those contained in the case at bar. The right of and liability to members in the cited case depended upon the discretion of the Board of Directors. The purpose of the Cooperative Marketing Act of the State of Idaho was to prevent such a situation, and the entire theory and all the provisions of the Act expressly set forth that all of such savings belong to the members as patrons and shall be distributed to them as hereinbefore mentioned. All payments made to members were made by reason of the statute, Articles, By-Laws and membership agreements. No resolutions of the Board of Directors and no act on their part whatsoever was necessary to authorize such payment. Any action that they may have taken with respect to authorizing such payments was mere surplusage. The funds belonged to the members, the payment of such funds was a legal duty imposed upon the officers of the association, and any act, either in setting up such funds as a liability or in authorizing payment, merely reflected such liability.

Accordingly, as stated in our opening brief, any act of appropriation or otherwise with respect to the payment of these savings to members or setting them up as a liability to such members merely reflected the absolute liability and duty fixed by law, Articles and By-Laws. The entire record shows the intent and understanding of Petitioner and its members at

all times was simply to carry out this conception and the liability and duty thus imposed.

As pointed out in our opening brief, regardless of what the account was named or designated, the savings evidenced thereby were "a liability to the members of Petitioner" (Brief, p. 13). Petitioner's manager testified that this account, no matter how designated or referred to, showed "the savings belonging to the members" (Brief, p. 14). That the members understood these savings were due them and a liability of Petitioner to them, is also apparent from the record, because as these members inquired as to the amount due them, Petitioner's officers would compute the same from the account involved and advise them that the association owed them a certain sum (Brief, pp. 15, 16). So likewise, when memberships were obtained the same statement was made to them; and the understanding at all times of the parties, both when memberships were obtained, when supplies were purchased or furnished, and when inquiry was made as to the amount due from Petitioner to its members, was that there was a definite and fixed liability of Petitioner to such members for the savings involved herein.

However, Respondent makes no effort to answer the argument with reference to such intent and understanding as set forth in our opening brief. He simply ignores the intention and understanding in good faith of these parties and relies, by reiteration, upon the word "reserve" in its technical sense. The testimony throughout the record shows that in these farmer cooperative organizations the officers and patrons are not lawyers or expert accountants, and loose language is

often employed in referring to transactions. Manifestly, however, regardless of nomenclature, the intent of the parties is paramount, and the account in question was kept in such a way that the liability of each patron could be determined at any time, and was so determined.

Merely because the word "reserve" was at times used, we find counsel assuming that the word was used as contemplated by its technical meaning and set up by the Board of Directors as permitted by the Articles, although the record clearly shows that such a reserve never was set up by the Board of Directors, and the testimony is uncontradicted that the savings involved were an actual liability and obligation to the members, one of the officers in particular testifying: "It was not a reserve at all. It was merely liability account, carried as a liability on our balance sheet—as a liability to our members." (R., p. 73)

This position of counsel and the attitude of Respondent is contrary to the rule that the Government will not be permitted to resort to sharp practice nor to invoke technical constructions or fiction which will manifestly thwart the good-faith intention of its taxpayers for the purpose of casting a tax burden upon them. (Petitioner's Brief, pp. 17, 18).

Accordingly, it is manifest that counsel have misconceived the entire purpose and the provisions of the Cooperative Marketing Act of the State of Idaho; that the statement of counsel that an affirmative act of the Board of Directors is necessary to constitute a liability of Petitioner to its members (Brief, p. 7), is clearly erroneous, there being no discre-

tion in the Board under such Cooperative Marketing Act and the Articles pursuant thereto, the liability and duty being mandatory and fixed; that the statement of counsel that the proceeds from Petitioner's sales to its members belong to Petitioner (Brief, p. 9) is contrary to the purpose and statutory provisions of the Cooperative Marketing Act; that under such Act such savings can not belong to a member or stockholder as such, and counsel ignores the statutory provisions in their statement that such interest "is not greater than that of a stockholder" (Brief, p. 10); that under said Act and Articles the interest of members in savings becomes absolute when such savings are made, and counsel misconceives the entire purpose of the Cooperative Marketing Act of Idaho when they state that "such interest ripens into an individual ownership or right of ownership only upon declaration by the Board of Directors," no discretion in such board being permitted under the Idaho law and Petitioner's Articles; that Respondent by closing his eyes and ignoring the testimony throughout the record showing the intent and understanding of the parties can not, by invoking technical constructions or fictions, thwart such intention and understanding and thus cast a tax burden upon Petitioner; that Petitioner under the Cooperative Marketing Act of Idaho can neither suffer loss nor enjoy profit, the savings belong to members as earned and the right to set up certain reserves is only a limitation on Petitioner's liability to members; that the savings in question were not such a reserve, as shown by the record.

The entire record shows that all parties construed the purpose and provisions of the statute, Articles, By-Laws and marketing agreement as creating a liability and obligation on the part of Petitioner to its patrons for the savings involved. When memberships were solicited such representations were made and clearly understood. Both officers and patrons understood that this account represented a liability of Petitioner to its patrons, and to each of them in accordance with the amount as shown by this account, the work sheets, and individual folders. Under these circumstances the liability involved of Petitioner to its patrons was clear, and no distribution or other act by Petitioner was necessary.

We respectfully submit, therefore, that the savings involved in this matter were properly deductible and that there is no deficiency in either Petitioner's income or excess profits taxes, and that the holding, finding and decision of the Board of Tax Appeals is erroneous and should be reversed, vacated and set aside.

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